SECTOR SEVEN
Governance. Risk. Compliance.

20 July 2012

The Committee Secretary
Standing Committee on Economics
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CANBERRA ACT 2600

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Dear Sir,

EXECUTIVE SUMMARY

This submission is a response to the Exposure Draft of the Australian Charities and Not-for-profits Commission Bill 2012 (the Bill) released for comment by the Assistant Treasurer on 6 July 2012.

We set out our particular comments with respect to:

1. Eligibility for registration and the revocation process.
2. The amount of information that the ACNC may make available in a public register, particularly in circumstances where there may not be procedural fairness and where public sanctions might be very damaging to the ongoing operations of some charities.
3. The lack of detail provided about the proposed Governance Standards and External Conduct Standards and the need for further consultation on these standards.
4. The Duty to Notify set out in the Bill.
5. The potentially onerous information gathering powers available to the ACNC that have the ability to impose an unreasonable burden on the resources of charities.
6. The Enforcement powers set out in the Bill.
7. The obligations and liability of covered entities.

INTRODUCTION

This submission is made on behalf of Sector Seven Consulting Pty Limited, a boutique professional services consultancy with specialist expertise in the disciplines of governance, risk and compliance. Sector Seven has considerable experience in governance, compliance, regulation and policy in the government, corporate and

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financial services sectors, with each contributor having held senior executive roles in the Australian Securities and Investments Commission (ASIC). We have a strong interest in contributing our experience to the not-for-profit sector as we are keenly aware of the vital social and community importance of the sector. We believe our extensive regulatory experience enables us to contribute some practical insights into the implementation of this new regulatory regime for the Australian charity sector.

We recognise that there is limited time for consultation on the Exposure Draft. In light of this, we have concentrated our submission on a relatively few areas where we believe we can provide the most useful practical comments. We note also the considerable challenge in adopting a scaled regulatory regime for such a diverse sector that ranges from micro-organisations, primarily reliant on voluntary resources, through to large multi-national charity organisations with considerable resources and large funding bases.

We are generally supportive of the thrust of the legislation as it seeks to strengthen the NFP sector's transparency, governance, and accountability. We welcome the more flexible principles based approach, the existence of scalable obligations, the legislative guidelines on enforcement principles, the 'report once' concept and the Advisory Board. It is important however that a good balance be obtained between driving continuous improvements across the sector and imposing prescriptive standards and regulatory burdens that are difficult to tailor to the very different types of organisations in the sector. If this balance is not achieved, there is the potential to make it impossible for all but the largest organisations to effectively manage their response. For this reason we think a highly consultative approach and a considerable degree of transparency from the ACNC is particularly critical in the implementation of this new regulatory regime.

In making our submissions, we have considered the following two questions:

- Does the Bill achieve its mission to provide a principles based framework and to simplify regulatory arrangements for the NFP sector?
- How does the Bill serve a unique and diverse sector whose mandate is the achievement of a community, altruistic or philanthropic purpose to focus on that mandate?

KEY SUBMISSIONS ON THE BILL

1 Registration and Revocation

Chapter 2 of the Bill sets out the procedures in relation to registration and revocation of registration of NFP entities.

NFP entities must be registered with the ACNC in order to access certain Commonwealth concessions, exemptions and benefits. These benefits are essential for the successful operation of most NFP entities and, as such, the entitlement to registration and continued registration will be a matter of key significance to NFP entities that rely on Commonwealth assistance. We recognise that a registration regime provides the ACNC with a framework for regulation but it must also be

recognised that the regime has the potential to inhibit innovation, duplicate regulation and unnecessarily add to the cost of compliance if not managed appropriately. We have commented on some of these issues later in this submission but have specific comments in relation to the procedures for registration and revocation.

The provisions relating to registration and revocation are substantially similar to the provisions set out in the *Corporations Act 2001* (the Corporations Act) for the licencing of financial services operators and in the *National Consumer Credit Protection Act 2009* (the NCCP Act) for those engaged in consumer credit activities. However, there are some key, and we would submit material, differences.

Under the Bill, an entity is entitled to registration if it meets certain conditions, including the requirement to comply with the Governance Standards and the External Conduct Standards set out in Part 3–1 of the Bill. The problem with this provision as presently drafted is that it will be difficult for a NFP entity to demonstrate compliance with standards that have been newly established. It will be equally difficult for the ACNC to make an assessment about this and this has the potential to make the registration process unworkable for new entrants, particularly in the early stages of operation of the Bill. The Corporations Act addresses this issue by providing that ASIC must grant a licence if ASIC has "no reason to believe that the applicant will not comply" with the general obligations of licensees under the legislation. There is a similar provision in the NCCP Act. This would resolve the issue and give the ACNC flexibility to register new applicants that have standards and procedures in place to comply with those standards but no demonstrable history of compliance. It should also be noted that there is court and tribunal guidance on what the words "reason to believe" mean, which will be of assistance to the ACNC, NFP entities and those who advise them on these matters.

The second issue of divergence is the entitlement to a hearing where registration is refused or where revocation is proposed. There is no requirement in the Bill for the ACNC to give the NFP entity procedural fairness through written submissions or a hearing (unlike the Corporations and NCCP Acts). There are provisions for procedural fairness in respect of revocation but given the implications of revocation, we believe these provisions should replicate the provisions set out in the Corporations and NCCP Acts. Under the Bill, the ACNC must issue a "show cause" notice where it believes "on reasonable grounds that a registered entity is not entitled to be registered". The notice must set out the grounds on which the notice is given and invite the entity to provide a written response within 28 days. There is no provision for a hearing (as required under the Corporations and the NCCP Acts) and the ACNC may dispense with the show cause notice if "in the opinion of the ACNC it is reasonable to do so". It should also be noted that there are no circumstances in which ASIC may suspend or cancel a licence without first giving notice.

In summary, there are well established principles in the Corporations and the NCCP Acts for procedural fairness that we suggest should be incorporated in the Bill. In our submission, these provisions would not unduly complicate the process and ensure both the ACNC and the NFP entity were properly and effectively apprised of the key issues in dispute before embarking on a more expensive and time consuming appeal process.

2 ACNC Register

We are concerned about the proposed content of the Register as set out in Section 40-5 of the Bill and in particular sub-section (f). While we agree that achieving greater transparency is an important aim for the sector, the ability to publish details of what might, in some circumstances, be seen as relatively light touch regulatory sanctions, such as Warning Notices and Directions, carries a disproportionate risk of causing significant reputational harm, particularly to smaller to medium-sized charities.

It is possible to envisage the existence of public warnings or directions threatening the ability of these organisations to continue raising funds. This might be the case even though the identified shortcomings that have led to the warning or direction have not been considered sufficiently egregious as to warrant more serious regulatory intervention. This concern is exacerbated in circumstances where it is not clear that there is any requirement to give procedural fairness to an entity prior to the issue of a Warning Notice or Direction. In this respect, the ability to publish potentially damaging material is far greater than is the practice for other regulators, for example the corporate regulator, ASIC, which operates in a far more restrictive environment with respect to publishing the results of its inquiries. In our view, while transparency is critical to establishing public confidence in the sector, both the ACNC and its regulated population needs to be able to work with confidence in the implementation period that minor transgressions and regulatory interactions are not necessarily immediately subject to public scrutiny.

While we acknowledge that there is discretion for the ACNC to decline to include information on the Register, it is important that, at the very least, clear guidance be provided on how this discretion might be used, in order to provide a degree of certainty and confidence for registrants.

3 Governance Standards

It is noted that while the Bill at Section 45-10 proposes that regulations enable specifying Governance Standards, there remains little detail about the proposed scope or content of those standards. It is therefore difficult to comment on these proposals, or how they may operate in a way that is scalable and practical for the wide spectrum of entities likely to be subject to any such standards. In this context, it will be crucial that there be appropriate consultation on the draft content of any regulations and that there be ample opportunity for engagement and comment by participants across the sector.

It strikes us that it will be almost impossible to derive across-the-board standards that are suitable for everything from the smallest to the largest organisations, recognising their different objectives, funding models, access to expertise and resources. It is also the case that, even in the heavily regulated corporate and financial services areas, there is a tendency to favour largely voluntary, industry-endorsed codes, rather than imposing prescriptive arrangements by way of regulation. This recognises that all organisations need to have the flexibility to ensure that their organisational arrangements are appropriately designed to ensure the effective achievement of their objectives.

There are excellent examples already of governance standards being developed cooperatively across industry. The ASX Corporate Governance Principles and Recommendations were developed with broad stakeholder input and have continued to be reviewed on that basis in light of practical experience. It is also noteworthy that the emphasis remains chiefly on disclosure of practices, rather than prescriptive compliance, enabling entities to exercise considerable flexibility in their own arrangements.

Similarly, the Charity Commission for England and Wales appears to have struck a reasonable balance between having relatively few prescriptive requirements, while encouraging continuous improvement and best practice. The Commission also provided advice and support in the development of a Code by an industry partnership group, in order to clarify the principles and assist charities to meet the appropriate standards. This graduated and industry-driven approach has much to recommend it in a sector where the practices are likely to be diverse and the objective is to move towards better practice over time.

Our comments with respect to the need for consultation and flexibility in relation to any proposed Governance Standards apply equally to the provisions in Division 50 to specify External Conduct Standards by regulation.

4 Duty to Notify: self reporting

We note that the Duty to Notify provisions (set out in Division 65) have the dual roles of providing information to the ACNC about matters which may affect registered entities ongoing entitlement to registration and ensuring the maintenance of an accurate and up to date Register. In our view the rationale for self-reporting may be achieved by alternative means that impose a lower compliance cost burden on registered NFP entities whilst satisfying substantially the same regulatory outcomes.

The self-reporting obligation in the Bill has been modelled on the self-reporting obligations for Australian Financial Services Licensees as contained in Section 912D of the Corporations Act. In our experience, this provision has been a very difficult obligation for the regulated population to implement. We believe there have also been challenges for ASIC in assessing and managing self reported matters, although this was alleviated by ASIC issuing guidelines and special procedures for assessing matters reported. The financial services industry is generally well resourced and experienced in legal and regulatory compliance issues. In contrast, we expect that there will be many entities in the NFP sector that are not so well resourced and experienced.

The self reporting obligation as proposed is likely to be costly and resource intensive for small to medium charities in particular. In our experience, the typical management and resourcing of the self-reporting obligation under the Corporations Act requires regulated entities to establish and maintain documented policy and procedures and to train staff about those procedures. In this sector, that might also mean training volunteers who work periodically for the charity. Entities will need to develop a communications program for notification and a system for generating internal reports and recording them in a register to be made available to the regulator. They will also need to develop a system for assessing whether/which matters require regulatory reporting. Once a

reportable breach is identified, they will then need to prepare and submit a breach report and will need to determine who is authorised in the organisation to make the decision to report. Following a breach report they may also need to design and implement a management plan to correct the breach and ensure there is no recurrence, report regularly on status and ensure that there is satisfactory closure with the regulator. This process will usually require dedicated and ready access to compliance and/or legal resources.

NFP entities will need to adopt a similar approach to ensure compliance, particularly having regard to the fact that a failure to report would be a breach of the law and may entitle the ACNC to take enforcement action.

The anticipated time, cost, and resource challenges for NFP entities attempting to comply with the self-reporting obligation is exacerbated when the obligation is viewed in the context of the ACNC's monitoring powers under the Bill, as taken together, the potential range of matters in respect of which an entity may be required to self-report is extensive.

Given these matters, we submit that an alternative appropriate and sufficient regulatory response would be to incorporate self-reporting of clearly defined "significant contraventions" only within periodic compliance declarations (such as are anticipated to be required as part of the Annual Information Statement content to be prescribed by regulations). While there will still be a need to establish policies, procedures and systems for identifying, managing and reporting potential contraventions, in our view these procedures will be less onerous, more flexible and less time consuming. A periodic self reporting obligation would alleviate the need to have compliance or legal resources 'on tap' on an ongoing basis, which is likely to be more practical at the smaller end of the regulated population.

We also suggest that the ACNC may wish to consider developing guidance on what is considered to be a "significant" contravention, together with guidelines on how breach notifications should be made and how they will be treated (along similar lines as ASIC's Regulatory Guide 78).

5 Information-gathering powers

The information gathering powers in Division 70 are particularly wide and arguably more draconian than most comparable regulators, including, for example, those of ASIC. In some instances, these powers, unless used carefully, could create significant burdens on charities, particularly in light of the fact that most are unlikely to have significant resources to assist them to respond to regulatory requests for information.

Even in an industry where there are traditionally extensive compliance resources deployed, such as financial services, regulatory requests for information can at times impose a considerable burden on those resources and can prove a significant distraction from day-to-day business operations. In this sector, few will have access to full time compliance or legal resources, which means that responding to any regulatory request for information is likely to impose some burden. While we would not suggest that it is inappropriate for the ACNC to have wide powers to monitor industry conduct, there are some proposed powers that seem fraught with the risk of imposing an unreasonable burden.

As proposed, the ACNC may, by written notice, require an entity to give information ***in the manner and form specified in the notice*** (our emphasis) within a period set out by the ACNC. The ability to request information in a manner and form specified is potentially wider than an ability to obtain information or documents that already exist. The breadth of this power, unless used judiciously, could for example cause an entity to be required to actually prepare information it does not ordinarily hold, or in a form in which it is not ordinarily held. In our experience, these types of requests can be particularly burdensome for an entity required to respond. In our view, this power might be sensibly confined to an ability to obtain information already held by an entity.

Further, the power to require a person to attend and give evidence before the ACNC is very wide. It does not appear to require, for example, that the ACNC needs to form any suspicion of wrongdoing before exercising that power. This is in stark contrast to the powers held by ASIC. For example, ASIC also has wide information-gathering powers, but they are unable to compel a person to appear before them to give evidence unless they have formed a "reasonable suspicion" that there has been a breach of the law. There is no such threshold proposed in the Bill. Use of this type of power purely for the purposes of monitoring compliance seems to us to be very burdensome. Few people are likely to want to appear to give evidence in these circumstances without first seeking legal advice, which is likely to be costly and difficult to obtain without a clear understanding of what the ACNC is trying to test. We would suggest that any compulsory power to attend and give evidence should be restricted to circumstances where there is already a suspicion that there has been some breach of the law.

6 Enforcement Powers and Penalties

We have two key observations on Part 4.2 of the Bill. First, notwithstanding the intent that the ACNC be the single regulator, there is potential for regulatory duplication or overlap with other regimes such as those administered by ASIC, the ATO and the ACCC. Secondly, a number of the enforcement actions contemplated by the Bill appear to be more extensive than those provided for ASIC's administration of the Corporations Act. Given that this is a fundamental change for the NFP sector, this is surprising and seems to be unduly onerous.

We deal with each issue below.

Duplication

ASIC currently regulates some 11,000 NFP entities that are incorporated as companies limited by guarantee, as well as professional trustee companies and some charities that are incorporated as other types of companies, as well as incorporated associations and cooperatives that are operating outside of their home jurisdiction under the Corporations Act. Where a registered NFP entity is a company limited by guarantee, for example, it will remain subject to the Corporations Act creating clear duplication.

In our view the Bill should include specified carve outs depending on the legal entity status of an NFP entity in order to avoid the double jeopardy of dual regulation. This is also relevant to the

"covered entity" provisions referred to in 7 below which we note are also possibly inconsistent with the *Personal Liability for Corporate Fault Bill* (Liability Reform Bill).

Nature and extent of enforcement powers and penalties

We support a 'light touch' principles based approach to the increased regulation of the NFP sector as a sufficient and appropriate regulatory approach having regard both to the nature and diversity of the sector. We also welcome the regulatory enforcement guidelines set out in the legislation in Subsection 35-10 (2).

We note that the clear rationale for the ACNC's enforcement powers as expressed in the Explanatory Memorandum is to assist in maintaining, protecting and enhancing public trust and confidence in the NFP sector, deterring entities from acting inappropriately, and protecting assets from inappropriate use. The Explanatory Memorandum provides that the range of enforcement powers in the Bill enables the ACNC to take "proportional and targeted actions to address or lack of actions that could threaten public trust and confidence in the NFP sector" (EM 9.5). However, the enforcement provisions as drafted in the Bill are not subject to such limitations and a number of the remedies have the potential to be more extensive and reputationally damaging, with less checks and balances, than enforcement powers currently exercised by ASIC.

The application and necessity clauses are said to provide sufficient safeguards but from our reading of the Bill they are not applied consistently across the legislation and therefore do not have this effect.

Under the Bill the ACNC has seven key enforcement remedies available to it. They are revocation of registration, the issue of Warning Notices, Directions and administrative penalties, injunctions, the acceptance of enforceable undertakings and the suspension and removal of a responsible entity. We are supportive of and have no difficulty with the ACNC's power to accept an Enforceable Undertaking from an entity or with the court remedies.

The application and necessity clauses apply to four of the remedies (not administrative penalties) but we have serious concerns about the ACNC exercising these enforcement powers without first affording adequate procedural fairness. As referred to above in respect of revocation, this is out of step with ASIC obligations and is of particular concern in relation to suspension and removal of responsible entities. The issue of warning notices and directions has the potential to cause unnecessary harm and embarrassment because they are publicised on the ACNC Register, yet there is no opportunity for the NFP entity to respond before the issue and publication. This is heavy handed and could be resolved, either by providing procedural fairness before the issue of the notice or making warnings and/or directions private. We favour the middle ground, which is to include procedural fairness before the issue and publication of directions but allow the issue of Warning Notices that are not published but can be taken into account by the ACNC in exercising other enforcement remedies.

The example given at paragraph 9.83 of the Explanatory Memorandum highlights the potential harm that may be caused to a registered NFP entity the subject of a Warning Notice or Direction

(and the sector more generally) in circumstances where the ACNC allegation is subsequently disproved. Even though the ACNC Commissioner has power to remove a publication from the Register, it is likely that the harm will have been suffered. In our view, the lack of procedural fairness makes these remedies heavy handed.

The administrative penalties for false and misleading statements set out in Part 7.3 of the Bill are not limited by the application and necessity clauses. These penalties may be imposed by the ACNC without procedural fairness or the need to have a reasonable belief. They are similar to the administrative penalties set out in the taxation and other revenue legislation. Administrative penalties may be appropriate for the tax regime, which is based on self assessment of tax obligations, but we query the appropriateness of administrative penalties for regulation of the NFP sector. Corporations and licensees that make false and misleading statements to ASIC are not subjected to administrative penalties. They may be prosecuted or subject to a civil penalty process but there are inherent protections in the court system that are not available in an administrative process. It seems incongruous for NFP entities to face a more severe regulatory regime for breach than well resourced corporations and financial service providers.

A further issue of concern is that the amount of the administrative penalty for false or misleading statements is not scaled according to the size of the entity. There is precedent for this in ASIC's continuous disclosure infringement notice regime, which is based on market capitalisation. This could be significant for a small NFP entity that makes a misleading statement in error. The onus will be on the entity to establish the exception of "reasonable care" and this may be difficult for an inexperienced, small operator, which would be liable for a penalty of $2,200.

In relation to the remedies for suspension and removal of responsible entities, we accept the ACNC should have these powers in certain circumstances but we are concerned about the nature and extent of those powers and the lack of appropriate safeguards.

The ACNC has discretion to suspend or remove a responsible entity, which is broadly defined as a director of a corporate NFP or a member of the management committee of an unincorporated association and extends to individuals who act in those roles, similar to the concept of a 'shadow' director or manager. The threshold for the exercise of the discretion is that the ACNC must have a reasonable belief about non compliance or contravention by the NFP entity, must take into account the factors set out in Subsection 35(2) and must form the view that the suspension or removal is "necessary" to address the non compliance or contravention. In other words, both the application and necessity thresholds operate. This is appropriate. However, there is no procedural fairness afforded other than a notice setting out reasons for the decision after it has been made. There is no provision for the person to be provided with a notice prior to the suspension or removal or to be given the opportunity to respond. There is no right to a hearing in what is a powerful discretion that has the potential to impact significantly on the responsible entity's rights. It is also relevant to note that a responsible entity who is suspended or removed but continues in management may be prosecuted and sentenced to imprisonment of up to one year.

ASIC may ban directors, financial advisers and credit providers but before doing so it must afford procedural fairness, including a hearing. Given the implications of suspension and removal for a responsible entity, we submit that this basic protection should be included in the legislation.

The ACNC may also suspend a responsible entity but there are no guidelines or apparent limits on the period of suspension. In the absence of legislative guidelines it is critical that the ACNC develop guidelines on these matters for publication. If a responsible entity is removed, they cannot become a responsible entity but there is no time limit on the prohibition. This means the order for removal is indefinite. This is unduly onerous, particularly when there is limited procedural fairness afforded, and should be addressed in the final draft.

7 Covered entities – liability of directors and managers

Division 180 of the Bill imposes obligations, liabilities and offences on "covered entities" being those responsible for managing the registered NFP entity with the stated purpose of ensuring covered entities are "accountable for fulfilling the obligations in the Bill".

Where the registered NFP entity is an unincorporated association the effect of the provisions is to impose all of the obligations (as well as liabilities) of the unincorporated association on each member of the committee of management at the time the obligation arises or the liability becomes payable, and to render any offence of the unincorporated association as being taken to be committed by each member of the committee of management. There is similar application for trusts that are not corporate trustees.

Where the registered NFP entity is a trust (corporate trustee) or a body corporate obligation and liability is imposed on each director where the liability arises "because of the dishonesty, gross negligence or recklessness" or "deliberate act of omission" of the director (Section 180-5(2) (3) and (4)). The single offence of failing a requirement to comply with an ACNC Direction is also imposed on each director (Section 180 -20(1)).

In our view these liabilities and obligations are onerous for the NFP sector that typically relies upon the unpaid time and voluntary services of its directors and other officers. We provide the following example of the practical impact the "covered entity" provisions would have on a director of a "large" registered NFP entity that is a body corporate:

Example: The registered NFP entity gives an Annual Information Statement to the ACNC in the approved form (which must include certain compliance information and a declaration that any information contained in the document is true and correct –to be provided in the regulations). It transpires that some required information has been omitted from the document (not due to any deliberate act of omission or dishonesty by any director of the entity but rather due to some recklessness on the part of the directors in connection with record keeping and making the declaration) and the ACNC forms the view that the registered NFP entity has breached its relevant obligations under the Bill to provide information and to keep adequate records (at least the latter is a strict liability offence). The ACNC issues a Direction to the entity requiring the entity to provide the omitted information within a prescribed time frame and the entity fails to comply with the Direction. The ACNC imposes an administrative penalty on the registered NFP entity of 40 penalty units in respect of the failure to provide information. The amount of the penalty is determined at $5,280 on the basis of recklessness and that the entity has previously received a penalty notice. In addition, the ACNC imposes an administrative penalty in respect of the record keeping offence of 20 penalty units ($2,200).

We also note in relation to this example that if it were a "small" NFP entity, the director would still be liable to pay $5,280 because the administrative penalty for false or misleading statements is not scaled according to the size of the entity.

The imposition of corporate trustee and body corporate "covered entity" obligation and personal liability under the Bill is more onerous than the sanctions that would be applied to directors of corporations or mangers of financial services corporations, appears unnecessary, and should be removed from the Bill.

We would also note that such personal liability may possibly be inconsistent with the Liability Reform Bill released as an Exposure Draft in January as the first tranche of legislation issued by the Commonwealth government to fulfil its commitments under the COAG director's liability project. The aim of that project is the harmonisation across all Australian jurisdictions of personal criminal liability for corporate fault.

We trust that you find these comments helpful and would welcome the opportunity to participate in any further consultation on these important reforms.

Yours sincerely,

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Director

And signed on behalf of co-contributors

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